UNITED STATES DEPARTMENT OF THE TREASURY

Fiscal Year 2007 Budget Initiative: Division on Dynamic Analysis
Office of Tax Policy

- As part of the rollout of the FY07 Budget, the Treasury Department is announcing its further development of its capability for dynamic analysis of tax policy changes.

- Dynamic analysis, which incorporates the full gamut of behavioral responses, including how tax policy changes affect total output, has the advantage of emphasizing the economic benefits of many of the President's tax policy initiatives.

- Dynamic analysis will also help frame the public dialogue on tax reform by highlighting its economic benefits. This type of analysis is already being done by the Joint Committee on Taxation and the Congressional Budget Office.

- The President's FY07 Budget includes a budget item to establish a dynamic analysis division within the Office of Tax Analysis (OTA) at the Treasury Department. Treasury would hire a director and several staff for the division. Treasury anticipates that it will conduct a dynamic analysis of the tax proposals included in the President's Budget for the Mid-Session Review (in July).

- What is Dynamic Analysis? In analyzing the revenue effect of potential tax policy changes, Treasury routinely considers how taxpayers might respond to the changes, but does not consider how the overall economy might be affected in its official scoring of tax proposals. In analyzing a reduction in marginal tax rates, for example, Treasury considers that workers would take more of their income in the form of taxable wages and salaries, but not how the tax reduction might increase workers' total compensation or the overall size of the economy.

  Ignoring such macroeconomic impacts is not a problem when potential tax changes are relatively small. Large-scale tax reform, however, could have significant macro-economic effects, so it is important to supplement the traditional approach with fully dynamic analyses that consider how tax changes affect the overall level of resources employed in the economy and the efficiency with which those resources are employed.

- How does Dynamic Analysis differ from Dynamic Scoring? Dynamic analysis evaluates proposals to see how they would alter the overall level of economic activity. Dynamic scoring, by contrast, would take this a step further by estimating how the higher level of economic activity could translate into higher tax receipts.

  Under the current proposal, Treasury would commit to conducting dynamic analysis of major tax policy changes, but not to dynamic scoring. It is envisioned that dynamic analysis eventually might evolve into dynamic scoring as the models become more sophisticated and the approach becomes more widely accepted. Treasury plans to continue to rely on their traditional approach for "official" estimates of the revenue effect of the tax proposals, and to present dynamic analyses as supplemental information.